

**IN THE MATTER OF THE APPLICATION REGARDING CONVERSION
OF PREMIERA BLUE CROSS AND ITS AFFILIATES**

Washington State Insurance Commissioner's Docket # G02-45

PRE-FILED DIRECT TESTIMONY OF:

Gubby Barlow

President and Chief Executive Officer
PREMERA Blue Cross

March 31, 2004

CONFIDENTIAL and PROPRIETARY
NOT FOR PUBLIC DISCLOSURE

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Introduction

Q. Please state your name.

A. Gubby Barlow. My given name is Herbert Randle Brereton Barlow.

Q. Please state your employer, title and business address.

A. I am President and Chief Executive Officer of PREMERA and Premera Blue Cross (together "Premera" or the "Company"). Premera is located at 7001 220th Street SW, Mountlake Terrace, Washington.

Credentials

Q. Please describe your professional background.

A. I started my career in public accounting in 1973 in South Africa where I became a Chartered Accountant, the South African equivalent of a Certified Public Accountant (CPA). I spent eighteen months with Deloitte Haskins & Sells (a predecessor firm to Deloitte & Touche, together "Deloitte") in St. Louis between 1977 and 1979, after which I returned to South Africa. I became a partner in the audit division of Deloitte in Cape Town, South Africa, in 1982.

I moved back to the U.S. in November 1987 where I joined the Los Angeles office of Deloitte as a senior manager. I was certified as a CPA in 1988 and admitted to the partnership in June of 1989. I remained a partner in the firm until March, 1991, whereupon I joined HealthNet as the vice president of finance. HealthNet is a large multi-state health plan. My last position at HealthNet was Senior Vice President of Finance and Customer Service, and Chief Financial Officer of HealthNet California.

1 I left HealthNet in July, 1995 to join AHI Healthcare Systems, Inc., a physician
2 practice management company, as its Chief Financial Officer and Senior Vice President.

3 I left the company after it was sold in March 1997 and joined Premera Blue Cross.

4 I was hired as Premera Blue Cross' Chief Financial Officer. I held that position
5 for a short time, until I was appointed Chief Operating Officer. I became Premera Blue
6 Cross' President in December 1999. I have been President and Chief Executive Officer
7 of Premera and Premera Blue Cross since July 2000.

8 **Q. Please describe your educational background.**

9 A. I received a Bachelor of Commerce degree as well as a Master of Business
10 Administration degree from the University of Cape Town. A Bachelor of Commerce
11 degree is the equivalent of a Bachelor's Degree in Business in the United States. I have
12 completed the "Executive Program in Management" and the "Advanced Executive
13 Program in Maximizing Global Competitive Advantage" programs at the University of
14 California Los Angeles.

15 **Q. Are you a member of any professional organizations?**

16 A. Yes. I am a member of The American Institute of Certified Public Accountants
17 and the California Society of Certified Public Accountants.

18 **Q. Do you currently sit on the board of any companies or other organizations,
other than Premera or its subsidiaries?**

19 A. I am on the board of the National Institute of Health Care Management LLC, the
20 National Institute of Health Care Management Foundation, the Washington Healthcare
21 Forum, and the Board of Advisers to the Dean of the School of Nursing at Seattle
22 University. I am also a member of the Community Development Round Table of Seattle.
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1 In addition, as the Chief Executive Officer of a Blue plan I am also a member of the
2 Board of the Blue Cross Blue Shield Association.

3 **Q. What is the National Institute of Health Care Management Foundation?**

4 A. The National Institute of Health Care Management Foundation (the
5 “Foundation”) is a non-profit, nonpartisan organization dedicated to improving the
6 effectiveness, efficiency, and quality of America's health care system. The Foundation
7 disseminates research findings and analysis that promote and enhance access to health
8 care and the efficiency and effectiveness of health care services and delivery.

9 The Foundation conducts research, policy analysis and educational activities on a
10 range of health care issues. It fosters dialogue between the private health care industry
11 and government to find workable solutions to health system problems. The Foundation
12 gives awards each year for excellence in health care research and journalism. It also
13 serves as a clearinghouse for information on health care issues.

14 The Foundation is funded by its Blue Cross and Blue Shield members and, in
15 addition, receives funding from such sources as grants from the Robert Wood Johnson
16 Foundation, the Center for Disease Control and Prevention, the Department of Health and
17 Human Services, and the Health Resources and Services Administration.

18 **Q. Please describe the Washington Healthcare Forum.**

19 A. The Washington Healthcare Forum (the “Forum”) is a coalition of physicians,
20 hospitals, purchasers, and health plans that have joined together to improve the health
21 care system for Washingtonians. The Forum’s vision is “an efficient and effective
22 healthcare financing and delivery system that addresses the needs and concerns of
23 patients, providers, health plans, and purchasers.” Its mission is to “streamline and
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1 simplify healthcare financing and delivery across the state” and “advance a public
2 dialogue on sustainable solutions to the challenges facing the health care system.” The
3 Forum’s members include four local leading health plans, two statewide provider
4 associations, a statewide health plan association, three leading health systems, and
5 physician representation.

6 **Form A Statement**

7 **Q. Are you familiar with the statement filed with regulators in connection with**
8 **the proposed conversion of Premera and certain of its affiliates to for-profit**
9 **corporations?**

10 A. Yes. On May 30, 2002, Premera advised the Office of the Insurance
11 Commissioner of the State of Washington (“OIC”), the Attorney General of the State of
12 Washington, the Alaska Division of Insurance (“DOI”), and the Oregon Insurance
13 Division (“OID”) of its intent to reorganize Premera and certain of its affiliates from
14 Washington non-profit corporations to for-profit corporations.

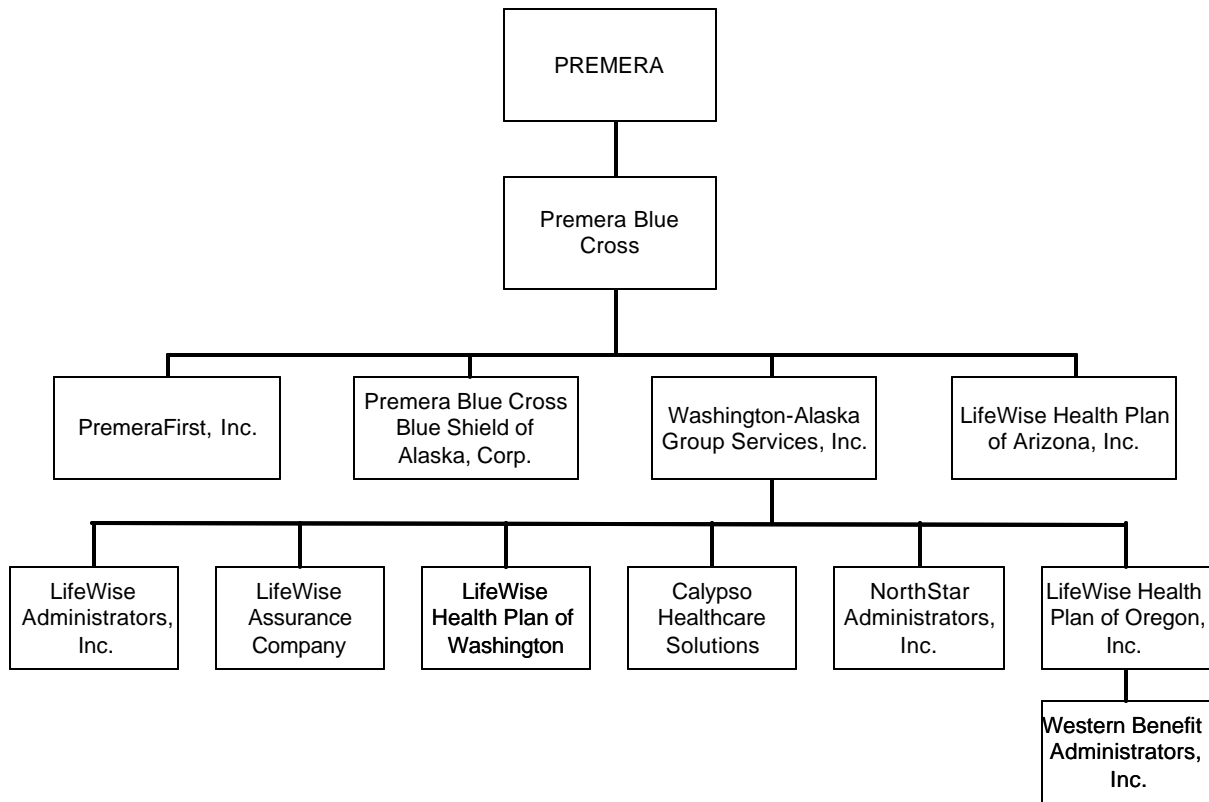
15 On September 17, 2002, Premera filed a “Statement Regarding the Acquisition of
16 Control of a Domestic Health Carrier and Domestic Insurer” (“Form A Statement”), the
17 formal application for approval of the reorganization. Premera supplemented the Form A
18 Statement on September 27, 2002 and October 25, 2002, and amended it on February 5,
19 2004. The Form A Statement, including its supplements and amendments, is
20 incorporated in this testimony by reference.

21 **Brief Description of Premera**

22 **Q. Please provide an overview of Premera’s organization.**

23 A. The current organizational structure of the Premera companies is as follows.
24

The PREMIERA Companies Organizational Structure



A description of each company is presented in Exhibit E-7 of the Form A Statement.

Present day Premera was created through the affiliation and eventual merger of two independent Blue plans in Western and Eastern Washington. Blue Cross of Washington and Alaska, the predecessor company to Premera Blue Cross, was registered as a health care service contractor in May 1945. It began selling health care coverage in Washington State in 1948 and in Alaska in 1957. In 1994, Blue Cross of Washington and Alaska affiliated with Medical Services Corporation of Eastern Washington ("MSC"), the Blue Shield plan based in Spokane, which had been serving Eastern Washington since 1933. At the time of the affiliation, PREMIERA was formed as the upstream holding company of Blue Cross of Washington and Alaska and MSC. In 1998, MSC merged into

1 Blue Cross of Washington and Alaska, and the name officially was changed to Premera
2 Blue Cross. PREMERA remains the sole voting member of Premera Blue Cross.

3 Premera Blue Cross is one of the largest Pacific Northwest health plans. It offers
4 a wide range of benefits for both fully insured and administrative services customers.
5 The Premera family of companies has operations in Washington, Alaska, Oregon, and
6 Arizona.

7 PREMERA and Premera Blue Cross are licensees of the Blue Cross Blue Shield
8 Association (“BCBSA”). Through that license and in accordance with the Blues’ quality
9 and financial assurance requirements, Premera Blue Cross offers healthcare coverage and
10 benefits administration in Washington using the Blue Cross and Blue Shield trademarks.¹
11 It offers healthcare coverage and benefits administration in Alaska under the name
12 Premera Blue Cross Blue Shield of Alaska.

13 The Premera companies also provide health care coverage, benefit administration,
14 and life insurance coverages through entities that are not licensed to use the Blue marks
15 or names. For example, LifeWise Health Plan of Oregon has been a member of the
16 Premera family since 1994. Premera also recently began marketing health care coverage
17 in Arizona through an affiliate known as LifeWise Health Plan of Arizona.

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¹ Premera Blue Cross operates using the Blue Cross trademark in all Washington counties, other than Clark
24 County. Additionally, it uses the Blue Shield mark in most eastern Washington counties.

1 In 2003 Premera's total operating revenue was \$2.8 billion. At 2003 year-end
2 Premera's fully insured and administrative services membership stood at approximately
3 1.5 million members, with approximately 1.3 million of those members in Washington
4 State. Premera currently employs approximately 3,200 people, with most working in
5 Washington State.

6 **Corporate Mission, Vision, and Values**

7 **Q. What makes Premera successful at serving its policyholders?**

8 A. Premera's business strategy is designed to meet its corporate mission and vision.
9 Premera's mission is "to provide peace of mind to our members about their health care
10 coverage." The vision is to be "the health plan of choice and the standard of excellence in
11 our region." Premera's corporate mission and vision are our guiding principles for
12 serving the company's current and prospective members.

13 **Q. Please explain Premera's corporate mission statement.**

14 A. Premera's corporate mission - "to provide peace of mind to our members about
15 their health care coverage" - recognizes that this is a consumer driven business. The
16 mission statement was established in 1998 by Premera's Board of Directors and
17 management team as they considered what Premera's value proposition should be for its
18 members - that is, why do people come to us as customers. We concluded that what
19 people want is the knowledge and the comfort that they have access to quality health care
20 and that their health plan will stand behind their healthcare coverage.

21 So what does that mean for Premera? To provide access to quality health care we
22 must offer a choice of coverage that meets the needs of our customers, coordinate
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effectively with the providers who care for them, and provide great service. To stand behind our member's health care coverage Premiera must be financially sound.

Q. Premiera has articulated the following corporate vision, "We are the health plan of choice and the standard of excellence in our region". Can you explain how that vision was developed and how you seek to achieve it?

A. As we were developing our corporate strategy in the late 1990's we understood that Premiera Blue Cross was well known, but we didn't feel it was the first plan people would automatically turn to when they were looking for health care coverage. We set a goal to be the plan of choice in all of our service areas. It's an ambitious goal—that when people think of health care coverage they think of Premiera first. Obviously, we want Premiera Blue Cross not only to be the first plan people think of, but also the plan they choose for their coverage. We strive to be the health plan of choice by being the standard of excellence. In other words, we work to provide excellent service, and our goal is to serve our customers better than the competition.

Q. Discuss how your corporate values support Premiera's mission and vision.

A. Among our corporate values are excellence, customer care, integrity and leadership. Those values are reflected in the way we conduct our business.

Excellence

We define "Excellence" as follows: "We deliver highly efficient and valuable service." Our goal in everything that we do is to provide excellent service that is valued by our customers. To be valued by our customers our service must be efficient and delivered at a reasonable cost. We are constantly re-examining how we achieve service excellence at the lowest possible cost.

1 For example, we recently undertook an extraordinary company-wide project
2 which set out to deliver a set of new products called Dimensions on a new systems
3 platform. We aimed to become highly efficient, with service valued by our members.
4 The dramatic success of our Dimensions product demonstrates that our customers
5 recognize the value of the services we deliver. I will discuss the Dimensions business
6 platform and products later in this testimony.

7 *Customer Care*

8 Premiera's second corporate value is customer care, which we define as follows:
9 "We anticipate, listen and respond to our customers' needs."

10 Listening means spending time with our customers to understand what they
11 expect of their health insurance company. Our role is to take what we hear from our
12 customers and to anticipate what would be helpful to them. To be successful we need to
13 anticipate what is, and will be, in the interests of our customers. We respond by
14 providing valuable services that are highly efficient to meet the needs of our customers.
15 Our steady growth shows that we are on the right track.

16 *Integrity*

17 Our third corporate value is integrity—"We do the right thing."

18 Integrity is instilled throughout the company. We pride ourselves on being
19 straightforward in our relationships with our customers, health care providers and
20 regulators. Those relationships thrive only if we consistently act with integrity.

21 *Leadership*

22 Premiera's fourth corporate value is leadership, which we define this way: "We
23 take the initiative."
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1 We try to make this value clear and concrete: in any given situation we will take
2 the initiative in solving a problem, whether it's for an individual customer or working
3 with others in the health care field to address industry-wide problems. Developing our
4 Dimensions business platform and products demonstrates Premera's initiative in finding
5 solutions for our customers. We believe Dimensions is unique in the Northwest for its
6 flexibility and breadth of coverage.

7 **Q. You mentioned the Dimensions business platform and products. How does**
8 **Dimensions serve the needs of Premera's customers?**

9 A. The Dimensions business platform, comprised of systems and administrative
10 processes, is designed to provide service at industry leading levels. The Dimensions
11 platform has enabled Premera to develop products which provide customers choice and
12 flexibility. We developed Dimensions to respond to consumer and provider frustration
13 with products that were inflexible, hard to understand, and complicated to administer.

14 Dimensions is an example of how investments address the changing demands of
15 our customers. In 2000, Premera reassessed its capabilities to determine how best to
16 meet emerging market demands. As a result, Premera undertook a major initiative to
17 redesign its entire delivery model, product portfolio, care facilitation approach and
18 systems infrastructure. We launched Dimensions in January 2003.

19 Premera wanted to make health care coverage a lot easier for everybody. And
20 that is the essence of Dimensions. From the members' perspective, benefits and networks
21 can be matched to best meet their needs. From the providers' perspective there is a
22 single set of administrative rules and a single payment method, independent of the
23 member's contract. Dimensions eliminates the complexity and confusion associated with
24 different rules and payments for old HMO and PPO products.

1 Dimensions clearly reflects Premera's commitment to responding to the needs of
2 our customers. So far we have invested approximately \$125 million in the Dimensions
3 business platform and products. In the short time since its rollout, Dimensions has been a
4 resounding success in the marketplace. But it will take ongoing investments to meet the
5 evolving needs and expectations of our customers.

6 **Conversion Directly Supports Premera's Mission and Vision**

7 **Q. In your view, how will the proposed conversion help Premera meet its
8 corporate mission and vision?**

9 A. Premera can meet its potential to deliver on its mission and vision to current and
10 future customers if it has the financial resources to make ongoing investments and
11 support its capital base.

12 As described earlier, we have invested significantly in Dimensions, but these are
13 not one time investments, they are ongoing. Such investments are large relative to
14 Premera's capital reserves. Premera seeks equity capital to continue to invest in new
15 products, services, and infrastructure that will better serve our customers and meet their
16 expectations. Additional capital will also support continued membership growth which
17 helps spread costs across a larger membership base. Converting is the best way of
18 enhancing our capital to better serve our customers.

19 Premera is undertaking this conversion because access to equity capital creates
20 more resources to achieve our vision—to be the health plan of choice and the standard of
21 excellence in our region. It also provides resources to accomplish our mission—to
22 provide peace of mind to our members about their health care coverage.
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1 **Q. In your view, how will the proposed conversion help Premera support its**
2 **capital position?**

3 A. Access to equity capital enhances our ability to strengthen reserves to meet our
4 current and future obligations to policyholders. Capital reserves are measured using an
5 index called the Risk Based Capital (RBC) index. Our 2003 RBC level of 433 is among
6 the lowest of any Blue plan nationwide. We believe it is prudent and responsible to have
7 an RBC index of 500 to 600 in order to cover rapidly increasing health care costs;
8 adequately cover our membership growth; and provide a hedge against economic
9 uncertainties.

10 As a non-profit, our sources of capital are effectively limited to our profits.
11 Premera's operating margins are slim—last year, about 1.7% percent of premium dollars.
12 Access to equity capital helps ensure that Premera can maintain financial stability and
13 adequate reserves.

14 **Q. In your view, how will the proposed conversion help Premera deliver**
15 **improved new products, technologies and service?**

16 A. This is a highly capital-intensive business. Premera seeks equity capital to make
17 continued investments in products, services, and infrastructure that will better serve our
18 customers and meet their expectations. As described earlier, we have invested
19 significantly in Dimensions to provide customers with a new generation of products,
20 technology and services. We see opportunity to make investments to further develop our
21 products and processes, thereby facilitating more efficient and greater access to care.
22 Examples of such investments are discussed in Exhibit E-7 of the Form A Statement.
23 Further, Alan Smit, Premera's Chief Information Officer, has provided testimony
24 describing a variety of marketplace factors requiring Premera to invest in technology at

1 an accelerated rate. Those factors include: the competitive forces and expectations within
2 the marketplace, industry trends to information technology integration and connectivity,
3 and legislative and regulatory requirements.

4 **Q. In your view, why is membership growth good, and how will the proposed**
5 **conversion help Premera support a growing customer base?**

6 A. Premera's investments in improved products and technology have been successful
7 in attracting new members. Since year end 1999, membership has increased by 38
8 percent. More than 550,000 Premera members are now using Dimensions products.
9 With upcoming product enhancements, we anticipate increased demand, resulting in
10 continuing membership growth. As stated in Exhibit E-7 of the Form A Statement,
11 Premera's new system infrastructure can accommodate such increased membership.

12 We believe that membership growth is good for all members that Premera serves.
13 First, increasing membership is a natural result of responding to the needs of the
14 marketplace. Second, increased membership benefits existing and new members alike by
15 spreading our technology and infrastructure investments over a broader base, allowing
16 Premera to deliver more efficient service.

17 As we grow in response to customer needs, capital reserve requirements grow as
18 well. With profit margins in the 1-2 percent range, it takes years before profits from those
19 new members fully fund necessary reserves. However, Premera's risk based capital level
20 is immediately impacted on the day we enroll each new customer. Access to equity
21 markets helps Premera respond to future demand for our products by adding the
22 flexibility to raise capital as needed to support membership growth.

23 Premera is very much mission driven. It's not just some slogan on a poster. Why
24 does the company exist? Premera exists to serve its existing customers and new

1 customers who want to buy our products. Converting is the best way of enhancing our
2 capital to better serve our customers.

3 **Conversion Serves the Public Good**

4 **Q. Is the conversion, in your view, in the best interest of the general public?**

5 A. I believe it is. A conversion will enhance Premera's ability to remain a strong,
6 local, independent plan able to meet its mission and vision for the benefit of its members.
7 Premera is an important part of Washington's economy through the products and services
8 it sells and its position as a large employer in both eastern and western Washington.
9 Moreover, conversion will also provide hundreds of millions of dollars to serve unmet
10 health care needs of the residents of Washington and Alaska.

11 Premera has proposed to dedicate 100% of New Premera's initial stock on
12 conversion to charitable foundations in Washington and Alaska. This stock would be
13 sold in the public markets to create an endowment to fund health-related initiatives in
14 those states. We have proposed that the Washington foundation would be dedicated to
15 address these important needs:

- 16 (a) improving health education and awareness;
- 17 (b) improving the quality of health care and access to health care and related
18 services;
- 19 (c) addressing the unmet health care needs of low-income uninsured and
20 underinsured populations;
- 21 (d) supporting the education of health care providers to increase the number
22 of active physicians, including specialists, and nurses in medically underserved
23 areas;
- 24 (e) supporting programs aiming to (i) make health care delivery more
comprehensive and flexible, and (ii) develop and promote the most efficient uses
of health care facilities, resources and services;

1 (f) supporting community-based and culturally competent programs that may
2 address one or more of the foregoing purposes;

3 (g) conducting health policy research and analysis for the development of
4 health policy that will promote systemic change in the programs and activities
5 related to the foregoing purposes; and

6 (h) providing grants and establishing programs to carry out such purposes.

7 Blackstone, the Washington State investment banking consultants, estimated that
8 the value of Premera is between \$500 and \$700 million. Further, E. Lewis Reid, the
9 former CEO of the The California Endowment, testified that if the amount realized by the
10 Foundations were in the range reported by Blackstone, the amount per capita available to
11 health philanthropy in Washington and Alaska would be equivalent to the largest
12 foundation ever created in a Blue Cross Blue Shield conversion.

13 **Q. How is a conversion in the best interests of your subscribers and will it effect
14 Premera's corporate mission, vision, or values?**

15 A. Premera's corporate mission, vision, and values will not change as a result of this
16 conversion. We exist to meet our customer's needs and expectations for health care
17 coverage. The whole purpose of pursuing access to the equity markets is to support
18 meeting those needs and expectations.

19 **Premera as a Local, Independent Plan**

20 **Q. The Board of Directors has determined that Premera's mission and vision
21 can be best achieved as an independent, Washington-based company. How is
22 that so?**

23 A. As an independent, local company the directors, managers and employees have
24 personal understanding of our communities and the needs of our customers and health
care providers. That makes it possible for us to tailor our products and services to meet

1 those needs. We believe the way we serve customers distinguishes us from companies
2 directed from far off headquarters.

3 We can do some things better than the national competitors. We are more “high
4 touch.” We are able to provide superior service to our members in part because we live
5 and work in this community. While there are always hard issues to resolve between
6 providers and insurers, Premera maintains close relationships with local hospitals, clinics,
7 physicians, and other health care providers.

8 **Q. How does your corporate form affect your ability to remain independent?**

9 A. There is no assurance of maintaining independence as a for-profit any more or
10 less than as a non-profit. The best way to remain independent is to have the financial
11 flexibility and strength to compete effectively and serve your customers well.

12 The fact of the matter is that many Blue non-profits around the country have lost
13 their independence through affiliations and mergers. In the early 1980’s there were 125
14 separate Blue Cross Blue Shield plans. Long before the first Blue conversion, that
15 number dropped dramatically. By 1996 the number of plans dropped by half to 63, and
16 today there are approximately 41.

17 Being publicly traded does raise the possibility that the company could be subject
18 to a takeover effort despite our intent to remain independent. We have adopted anti-
19 takeover provisions, except to the extent requested otherwise by the state consultants.
20 Moreover, any effort to acquire New Premera would need approval by the Washington
21 Insurance Commissioner under the same Holding Company Act standards as apply to the
22 conversion itself. In addition, our amended conversion application gives the Washington
23 Foundation, whose board is to be appointed by the Attorney General of Washington, the
24

1 right to vote freely on any acquisition effort by a third party of New Premera that is
2 recommended for shareholder approval by the New Premera Board.

3 **Blue Cross Blue Shield License Requirements**

4 **Q. What is the role of the Blue Cross Blue Shield Association regarding**
5 **conversions?**

6 A. The Blue Cross Blue Shield Association owns the Blue Cross and Blue Shield
7 trade names and trademarks. Premera, as a BCBSA licensee, has the right to use the
8 names and marks in its licensed service areas. A condition for that right is compliance
9 with the BCBSA license and related rules.

10 One of the licensure requirements is that no non-institutional investor may own
11 more than 5% (less one share) of the stock of a Blue licensee. The BCBSA has, on a case
12 by case basis, made a temporary exception to this requirement in prior conversions to
13 allow converting Blue plans to transfer their initial stock at the time of conversion to
14 charitable foundations, similar to the transfer proposed in the Premera conversion. That
15 exception requires, among other things, that the foundations sell their stock in the
16 converted plan to under 5% according to a BCBSA approved divestiture schedule. The
17 BCBSA may, consistent with its right under the license agreement, impose any other
18 condition for the waiver of the 5% ownership limitation.

19 The BCBSA does not dictate whether a plan may or may not convert, and does
20 not dictate conversion terms to state regulators. It will, however, strip a plan of its Blue
21 license if the plan proceeds with a conversion without an approved license exemption
22 with terms satisfactory to the BCBSA. The Blue Cross Blue Shield license is a
23 significant asset of Premera. Accordingly, Premera would only pursue conversion if it is
24 done consistent with BCBSA licensure requirements.

1 **Q. Does the Premera conversion as structured meet the BCBSA conditions for**
2 **obtaining the license exception?**

3 A. The Premera conversion filing has been submitted to the BCBSA for review.
4 BCBSA staff has confirmed that the filing does meet BCBSA requirements with the
5 exception of a small number of provisions that, as we have been recently advised by
6 BCBSA, require further discussion. I will address those items momentarily.

7 **Q. The state consultants in their supplemental reports assert that the two**
8 **foundations should be entitled to certain rights which Premera did not**
9 **include in its conversion filing. Please comment.**

10 A. Premera's original conversion filing proposed one foundation to receive 100% of
11 the initial stock of New Premera at the time of conversion. As explained in Mr.
12 Marquardt's pre-filed testimony, at the insistence of state consultants, Premera changed
13 the transaction structure to provide for two foundations, one for Washington and one for
14 Alaska, which are to receive the initial New Premera stock in an allocation to be
15 determined by the states.

16 The state consultants further asserted that, with the establishment of two
17 foundations, (i) each foundation should be allowed to hold 5% (less one share) of the
18 Premera stock free of all restrictions, (ii) each foundation should have a right to name a
19 slate of candidates from which a "Designated Member" would be nominated to the
20 Premera Board (or, in the alternative, in addition to a Washington Foundation Designated
21 Member, the Alaska Health Foundation should be allowed to have an observer at the
22 Premera Board), and (iii) each foundation should be subject to a separate, stand-alone
23 divestiture schedule for its Premera shares (collectively the "Duplicate Foundation
24 Rights"). As testified by Mr. Marquardt, BCBSA staff indicated they would not
recommend approval of the Duplicate Foundation Rights, and that such rights would

1 violate the BCBSA license. Accordingly, Premera's amended Form A filing of February
2 5, 2004 does not contain such rights.

3 Although Premera's amended conversion filing does not contain the Duplicate
4 Foundation Rights sought by the state consultants, Premera has endeavored to obtain
5 BCBSA approval for such rights. Shortly after the filing, we requested a special meeting
6 of the Plan Performance and Financial Standards Committee ("PPFSC"), the BCBSA
7 Board committee that considers license exception proposals in connection with
8 conversions. The purpose of Premera's request was to petition the PPFSC to approve the
9 Duplicate Foundation Rights.

10 The PPFSC granted the request for the special meeting, which was held on March
11 18, 2004. I personally attended the meeting, accompanied by Premera's Chief Legal
12 Officer and Premera's General Counsel. Prior to the meeting we submitted a position
13 paper advocating for the Duplicate Foundation Rights (the "Premera Position Paper"). A
14 copy of the Premera Position Paper is attached hereto as Exhibit A, and will be marked as
15 a Premera Hearing Exhibit. At the meeting my staff and I advocated for PPFSC to
16 approve the Duplicate Foundation Rights. We have recently been advised that the
17 PPFSC made the following determinations. PPFSC would recommend to the BCBSA
18 Board, for its consideration, two Designated Members on the New Premera Board, one
19 for the Washington foundation and one for the Alaska foundation. However, the PPFSC
20 has decided against two 5% (less one share) free voting blocks and against separate
21 divestiture schedules. A copy of a letter received from BCBSA's General Counsel,
22 stating more fully the PPFSC's decisions, is attached hereto as Exhibit B (the "BCBSA
23 Response Letter"), and will be marked as a Premera Hearing Exhibit.
24

1 **Q. You mentioned earlier that BCBSA Staff identified a small number of**
2 **provisions in the Premera conversion filing which they have issues. Please**
3 **comment.**

4 A. The provisions raised by BCBSA staff, and Premera's response to those issues,
5 are described in the Premera Position Paper. The BCBSA Response Letter indicates that
6 PPFSC has authorized BCBSA staff to continue discussions with Premera concerning
7 those issues.

8 **Conversion Promotes the Interests of Policyholders & the Public**

9 **Q. How does the revised conversion proposal address the concerns that have**
10 **been raised?**

11 A. The initial reports of the state consultants raised concerns about a host of issues
12 ranging from the impact of the conversion on premium rates, to the foundation's structure
13 and independence, to post-conversion stock programs. We took all the concerns
14 expressed with the utmost seriousness and worked diligently to understand and address
15 them. Consistent with Commissioner Kreidler's orders, Premera representatives met
16 extensively with representatives of the Washington Office of Insurance Commissioner
17 and the Alaska Division of Insurance over a two month period to try to narrow the issues
18 in dispute. Counsel for interveners was afforded an opportunity to observe all such
19 meetings.

20 The product of those discussions was the revised Form A Statement filed on
21 February 5, 2004. Notwithstanding that some issues remain, enormous progress has been
22 made. Premera made substantial changes to its conversion proposal. It further provided
23 economic and compensation assurances developed in conjunction with and based on
24 input from the state consultants. The Form A Statement changes and the assurances
reflect Premera's genuine interest in accomplishing our conversion in a responsible

1 manner. To address any concerns about potential premium rate increases resulting from
2 the conversion, we developed, in consultation with the state consultants, assurances about
3 our rate setting methodology. To address any concerns about the propriety of stock
4 option plans, we developed, in consultation with the state consultants, a stock plan and
5 assurances about compensation that result in what I believe is the most restrictive stock
6 plan of any Blue conversion. To address any concerns about the independence of the
7 foundation, we proposed and adopted provisions for the Attorneys General to appoint the
8 boards of the foundations. These are only a few examples of our substantial efforts to
9 address the state consultant concerns. More importantly, they reflect our commitment to
10 develop a conversion proposal that not only meets the letter of the Holding Company Act
11 requirements, but promotes the interests of our policyholders and the insurance buying
12 public while creating a legacy to the health of the citizens of Washington.

13 **Q. Does this conclude your testimony?**

14 **A.** Yes, it does.
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PREMERA'S PROPOSED CONVERSION
ISSUES FOR CONSIDERATION BY THE PPFSC

INTRODUCTION

PREMERA and Premera Blue Cross (collectively, "Premera") propose to convert from non-profit corporations to stock corporations. The conversion proposal is subject to approvals by the Washington State Insurance Commissioner, the Alaska Director of Insurance, and the Washington State Attorney General. The conversion proposal also must meet BCBSA licensure requirements and, to the extent of deviations from such licensure requirements, is subject to the approval of the BCBSA Board.

The Washington Insurance Commissioner will hold the formal Washington conversion hearing in early May 2004. The Alaska Director of Insurance will hold the formal Alaska conversion hearing in early June 2004. In the meantime, the conversion proposal has been reviewed by the states' insurance department officials and their consultants, who have issued formal reports and recommendations to the Washington Commissioner and the Alaska Director on the conversion proposal, and will present their positions at the formal hearings.

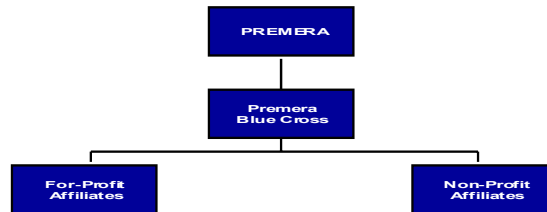
The states officials and their consultants have raised various issues concerning the proposed transaction. In particular, they object to three provisions in Premera's proposal that are described in this document. Premera structured its proposal with respect to these provisions to meet BCBSA requirements, as understood by Premera from guidance from the BCBSA staff. Premera believes the provisions objected to by the states are not inconsistent with provisions approved by BCBSA in other conversions. Premera, if its conversion proposal is approved by BCBSA, will include the changes requested by the states' consultants, as described below. Accordingly, Premera seeks formal guidance from the PPFSC as to its position on these issues so that Premera may, as soon as possible, determine if it has BCBSA permission to include these features in its conversion proposal.

OVERVIEW OF PROPOSED CONVERSION

PREMERA is a primary licensee of the Blue Cross Blue Shield Association (BCBSA). It is also the upstream holding company of Premera Blue Cross, which is licensed as a Large Controlled Affiliate under BCBSA licensure requirements. Premera Blue Cross has operated under the Blue marks in

Washington since 1933 and in Alaska since 1957. An illustrative chart of the current Premera family of companies is provided below:

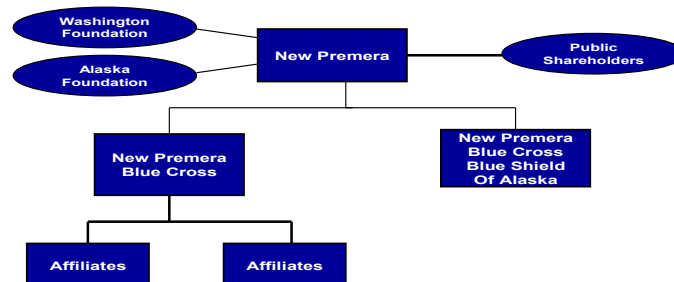
Current Premera Structure



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PREMERA proposes to convert it and its non-profit affiliates to stock companies. The conversion will provide Premera with access to equity capital markets to enhance its capital position, allow it to grow to achieve economies of scale, and provide for investments in infrastructure and technology. The conversion, if approved, will occur through a series of transactional steps, the result of which is illustrated by the following organizational chart:

Proposed Final Premera Structure



7

Under this structure, Premera will become the publicly-traded company and issue its initial stock to two foundations - a Washington foundation and an Alaska foundation (individually a “Foundation” and collectively the “Foundations”). The two Foundations are being created because Premera has operated in both states under separate insurance licenses issued by each state even though the operations have been conducted through a single legal entity.

At Premera’s IPO, which will be held simultaneously with its conversion, Premera will offer new shares to the public and the Foundations may sell some of their Premera shares to the public. The two Foundations, through the divestiture of the Premera stock held by each, would fund health initiatives to address the distinct unmet healthcare needs of their respective states. Each Foundation will be governed by separate boards of directors, the members of which will be chosen by the respective state attorneys general of Washington and Alaska.

While the Foundations will “hold” the initial Premera stock, they will possess the beneficial ownership in the stock and transfer, except in certain limited circumstances, the voting rights in the stock to a third-party trustee who will vote the stock as directed by Premera’s Board. The Foundations will be required to divest the Premera stock over a pre-determined period. The terms and conditions for the sale of the Premera stock held by the Foundations and the exercise of certain limited voting rights by the Foundations are generally consistent with several BCBSA-approved conversions¹, notably WellChoice.

With respect to Premera’s proposal, as recently amended, the states have asserted that each Foundation should have the rights that have been afforded to foundations in other conversions of Blue plans or otherwise permitted by the BCBSA, in the three areas discussed below:

(1) Each Foundation should be able to freely vote 5% (less one share) of the outstanding common stock of Premera held by them (the “5% Voting Blocks”) on matters submitted to all Premera shareholders for approval (e.g., election or removal of Board members, and Board-approved corporate transactions, amendments to the articles of incorporation and management stock plans).

(2) Each Foundation should identify a candidate (a “Designated Member”) to be included in Premera’s nominations for directors that will be submitted to Premera’s shareholders for election (alternatively, the Washington Foundation should be able to have a Designated Member and the Alaska Foundation should be able to have an observer with certain observation rights at Premera’s Board meetings).

(3) Each Foundation should be subject to an independent, stand-alone divestiture schedule for the disposition of its Premera shares.

PRESENTATION OF ISSUES AND PREMERA’S POSITION

The following issues are presented to the PPFSC for consideration and Premera’s position is provided for each issue.²

¹ BCBSA staff has reviewed Premera’s proposed conversion documents. The BCBSA staff has identified a limited number of provisions that the staff believes should be modified to be consistent with the WellChoice conversion. Those issues will also be discussed by Premera at the March 18 PPFSC meeting. Attached as Exhibit A to this document is a list of issues raised by BCBSA staff and Premera’s position on those issues.

² As currently drafted, Premera’s conversion proposal provides that there be only one 5% Voting Block if BCBSA does not approve two 5% Voting Blocks; that there be only one Designated Member on the Premera Board of Directors; and that there be a single combined divestiture schedule for both Foundations.

1. The states of Washington and Alaska have stated that each Foundation should be able to vote a 5% Voting Block on matters submitted to all Premera shareholders for approval (e.g., election or removal of Board members, and Board-approved corporate transactions, amendments to the Premera charter and management stock plans).

Premera's Position:

- Premera requests that the PPFSC approve allowing each Foundation to vote a 5% Voting Block on matters submitted to **all** Premera shareholders for a vote.
- Premera submits that permitting each Foundation to vote its 5% Voting Block is consistent with WellChoice in that each New York Fund created by the WellChoice conversion also can vote their respective 5% Voting Blocks.
- The BCBSA staff states that the Premera proposal is distinguishable from WellChoice in that the two Foundations in the Premera conversion will exceed the BCBSA's 5% ownership limitation at the time of the conversion, compared to the WellChoice conversion where only one of the WellChoice Funds exceeded the 5% ownership limitation.
 - Premera submits that, while the BCBSA staff's factual description is accurate, the two Funds created by the WellChoice conversion nevertheless are able to freely vote their respective 5% Voting Blocks on shareholder matters, as is proposed by the states in the case of Premera's proposal.
- The BCBSA staff also is concerned that having two Foundations, each with a 5% Voting Block, could have an unacceptable influence over Premera in the early days or years following the IPO when there is a relatively smaller public float.
 - Premera submits that this possibility also was present in WellChoice's conversion/IPO, yet the WellChoice model nevertheless received BCBSA approval.
 - The BCBSA staff argument may give too much weight to the two 5% Voting Blocks. In the early years of Premera's status as a public company, a significant portion of the Premera shares held by the Foundations must be voted as directed by Premera's Board on certain matters submitted to the shareholders (e.g. election of Board members).

- The BCBSA staff also raises concerns that, if the Foundations created from the Premera conversion are each permitted to have 5% Voting Blocks, then this feature could be compounded in the future if a three state Blue plan, for example, seeks to convert.
 - Premera submits that BCBSA rules require that if any two shareholders (whether foundations, other non-institutional shareholders, or institutional shareholders) act in concert or by shareholder agreement, they violate the BCBSA ownership rules and their shares are sold in a forced sale to an amount below the applicable ownership limitation threshold.
 - Additionally, Premera notes that, in this hypothetical example submitted by the BCBSA staff, having three 5% Voting Blocks available for the independent foundations to vote on shareholder matters does not materially distinguish it from WellChoice.
- The BCBSA staff believes that, even though the two Foundations that may be created by the Premera conversion are separate legal entities, they will have similar objectives that may result in the two Foundations effectively acting as one in the voting of their respective 5% Voting Blocks.
 - Washington and Alaska are two distinct states – demographically, politically, geographically, and with respect to the nature of their unmet healthcare needs and timing for addressing those needs.
 - By contrast, both Funds created in the WellChoice conversion are serving interests in the same state and are the pure result of the agreed transaction structure, not by the imperatives resulting from having two separate states involved.

2. The states of Washington and Alaska have stated that each Foundation should be able to offer a candidate (a “Designated Member”) for membership on the Premera Board of Directors (alternatively, the Washington Foundation should be able to have a designated board member and the Alaska Foundation should be able to have observer rights at Premera Board meetings).

Premera’s Position:

- Premera requests that the PPFSC approve allowing Premera to have up to two Designated Members on its Board of Directors

(alternatively, the Washington Foundation should be able to have a Designated Member and the Alaska Foundation should be able to have observer rights at Premera Board meetings).

- Premera submits that each Designated Member on the Premera Board must meet certain qualifications (public company experience) and an eligible Designated Member will be submitted to a vote by the public shareholders and the Washington and Alaska Foundations (in the latter case, solely with respect to their respective 5% Voting Blocks, if approved by the BCBSA).
- Premera also notes that all Board members, including the Designated Members, have fiduciary duties to **all** shareholders of Premera.
 - The BCBSA staff is concerned that the Designated Members will view themselves as representatives of the Foundations.
 - Premera notes that the Designated Members cannot by law act solely for the benefit of the Foundations and at the exclusion of other shareholders of Premera.
- If two Designated Members are permitted by BCBSA, they would hold only two of the fourteen Premera Board positions.
 - The BCBSA's staff is concerned that two Designated Members will influence a Board decision where the Board is divided on a matter.
 - Premera submits that two Board members could not control a board of fourteen members. The situation referenced by the BCBSA staff occurs only when there is a controversial matter where at least five other Board members have voted in opposition to the measure (assuming all fourteen Board members are present).
- Premera also notes that there is precedent for BCBSA allowing more than one director to be appointed by state officials to a Blue plan Board.
 - BCBSA agreed to multiple director positions to be designated to the CareFirst Board.
 - A number of non-profit Blue plans have more than one director position designated by state officials.

3. *The states of Washington and Alaska stated that each Foundation should have a separate divestiture schedule, rather than a single divestiture schedule, that requires the Foundations over a specified*

period to meet the BCBSA's ownership limitation (i.e. each Foundation would own less than 5% of the Premera stock issued and outstanding by the tenth anniversary of the conversion/IPO).

Premera's Position:

- Separate divestiture schedules provide additional flexibility for the sell down by the two independent Foundations and prevent the action (or inaction) from one Foundation adversely affecting the other; however, the practical reality is that the Foundations will be incented to liquidate their respective ownership of Premera shares to fund their grant-making activities.
- The BCBSA staff's position is that the Foundations should divest their Premera shares as soon as possible to mitigate the possibility of "influence" over the affairs of Premera.
 - Premera notes that "influence" is not manifested by economic beneficial ownership for several reasons: first, the stock is subject to voting trust limitations consistent with BCBSA requirements and, secondly, the voting rights that do apply would be separately held by two Foundations that are unrelated legal entities with separate boards of directors.

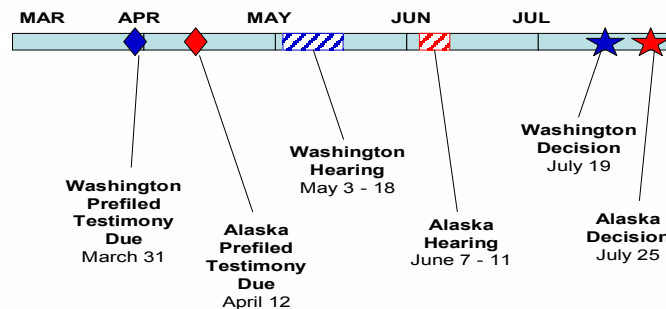
CONVERSION PROCESS TIMELINE

For the reasons described above, Premera believes that approval of the three transaction features, desired by the states' officials as described above, will not detract from its ability to conduct its operations and serve its members, and will be consistent with other conversion precedents approved by the BCBSA. Premera needs to know if the PPFSC would recommend to the BCBSA Board and the BCBSA Board would approve similar features for the Premera conversion so that it can indicate such position in a timely fashion in the administrative record for the Washington and Alaska proceedings.

The regulatory review and consideration of the conversion proposal is conducted through separate administrative proceedings in the states of Washington and Alaska. These proceedings are adjudicative in nature, i.e., the insurance commissioners in each state serve as judges and are "walled off" from the members of their respective staffs. The staff members are parties to the proceedings who review and analyze the proposal, and will recommend approval or disapproval of the proposal to their respective commissioners.

The administrative proceedings are progressing toward hearings in Washington state in May and Alaska in June. The Washington Insurance Commissioner and the Alaska Director of Insurance are scheduled to issue their

decisions on July 19 and July 25, respectively. The following illustrates the remaining timeline for the administrative proceedings:



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SUMMARY OF POSITIONS

Premera respectfully requests that the PPFSC provide formal guidance to Premera on its positions on the following matters:

- (1) whether each Foundation can be given a separate 5% Voting Block to vote on shareholder matters; and/or
- (2) whether Premera's Board of Directors may have up to two Designated Members who are selected through a process in which candidates are offered by the Foundations and eligible for election by shareholders (alternatively, a Washington Foundation Designated Member and an observer for the Alaska Foundation); and/or
- (3) whether each Foundation may have an independent, stand alone divestiture schedule.

In addition, Premera seeks PPFSC guidance on the other transaction terms raised by the BCBSA staff as listed in Exhibit A.

Premera appreciates the time and efforts of the PPFSC and the BCBSA staff in reviewing and considering these issues that are important to enhancing a successful outcome of the decisions related to its proposed conversion. We look forward to discussing these matters with you in more detail at the March 18 meeting.

EXHIBIT A

OTHER CONVERSION ISSUES RAISED BY THE BCBSA STAFF

The following contains other issues raised by the BCBSA staff regarding Premera's proposed conversion (highlighted in bold) and Premera's responses to same.

1. **Page 3; Def'n of Acquisition Proposal. The definition is too broad. Given that the Foundation will have consultation rights vis-à-vis Acquisition Proposals per Section 6.01, we believe the definition should be as in WellChoice.**

Premera Response: The definition of "Acquisition Proposal" contained in the Premera proposal is broader than WellChoice. However, Premera is only required to consult with the Foundations if Premera is "entering into a definitive agreement" regarding an Acquisition Proposal. In contrast, WellChoice's consultation rights apply even if the proposed acquisition has not progressed to a definitive agreement. Additionally, such definition in the Premera proposal identifies the types of acquisition proposals to which the Washington Foundation and Alaska Foundation are prohibited from soliciting or encouraging.

2. **Pages 6-9; Def'ns of Divestiture Deadlines. The additional delay for registration delays due to prior registrations serves only to delay the divestiture process. We believe the definitions should be as in WellChoice.**

Premera Response: As in WellChoice, the maximum period for any extension of the Divestiture Deadlines is capped. Based on advice of its financial advisors, Premera does not expect that this provision will practically add any delay to the overall divestiture process, and in any event this provision cannot operate to extend the relevant divestiture period beyond that allowed in WellChoice.

3. **Pages 12 - 13; Voting Rights. The additional right to vote on stock compensation plans should be deleted. We believe the rights should be as in WellChoice.**

Premera Response: The Foundation's right to vote freely on stock plans only applies if Premera wishes to amend those plans already agreed to with Washington and Alaska.

4. **Page 9; Pricing Committees. The Foundation should not be guaranteed a role in pricing committee decisions unless Foundation shares are being sold. Also, see Section 9 of the Registration Rights Agreement.**

Premera Response: We think there is a difference between the Foundation having a role in pricing committee decisions and having a director designated by the Foundation as having a role in such discussions. The “Designated Member” has fiduciary duties to all the shareholders of the Corporation, not just the Foundation. The Designated Member has a right to be on the pricing committee that discusses the sale of both the Corporation’s shares and the Foundation’s shares only for the first 3 years following conversion. Thereafter membership on the pricing committee by the Designated Member is limited to sales involving the Foundations’ shares. This was negotiated with the states as part of the anticipated role and committee membership of the Designated Member in the early years.



**BlueCross BlueShield
Association**

An Association of Independent
Blue Cross and Blue Shield Plans

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VIA FACSIMILE

March 29, 2004

Mr. H.R. Brereton Barlow
President and CEO
Premera Blue Cross
7001-220th Street S.W.
MS 316
Mountlake Terrace, WA 98043-2124

Re: ***March 18 Plan Performance & Financial Standards Committee
Meeting***

Dear Mr. Barlow:

I write to inform you of the results of the meeting of the Blue Cross and Blue Shield Association's Plan Performance and Financial Standards Committee (PPFSC), which took place on March 18. Thank you for attending that meeting with Messrs. Milo and Domeika. The PPFSC appreciated the time the three of you took to explain the contemplated Premera transaction.

As you know, Premera Blue Cross had requested a special PPFSC meeting to ask the Committee to recommend to the BCBSA Board and Member Plans certain terms that would modify the current structure of the conversion contemplated by Premera. Specifically, Premera asked whether the PPFSC would be willing to recommend to the BCBSA Board and Member Plans:

1. That BCBSA allow each of two charitable foundations (one for Washington and one for Alaska) to hold 5% (less one share) of New Premera's stock free of restrictions;
2. That BCBSA allow two "Designated Directors" on New Premera's Board, one for each of the foundations; and

Exhibit B

Mr. H. R. Brereton Barlow
Page Two
March 29, 2004

3. That BCBSA allow two separate divestiture schedules, one for each of the foundations.

After receiving and considering Premera's presentation and the presentations and recommendations of BCBSA staff, the PPFSC determined that:

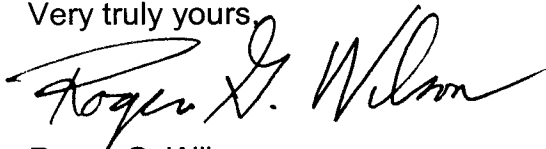
1. It could **not** approve or recommend Number 1 to the Board and Member Plans.
2. It could approve and recommend Number 2, assuming the transaction's terms are not materially altered. This concession is being offered on a one-time basis as an accommodation specifically applicable to Premera because of the nature of its dual-state business.
3. It could **not** approve or recommend Number 3. The PPFSC would be inclined to view the sell-down requirements for two foundations in the same way it has for the single foundations employed in prior conversions, i.e., provided the schedule complies with BCBSA sell-down requirements in the aggregate (e.g., a pro-rated divestiture schedule).

As you know, BCBSA staff have identified certain other drafting issues raised by the transaction documents Premera has shared with BCBSA. The PPFSC has authorized staff to continue discussions with Premera concerning those issues.

The foregoing action by the PPFSC should be understood to be subject to final Board and Member Plan determination and further review of an actual approved transaction.

Please let me know if I can provide you any additional information.

Very truly yours,

A handwritten signature in black ink, appearing to read "Roger G. Wilson", written in a cursive style.

Roger G. Wilson